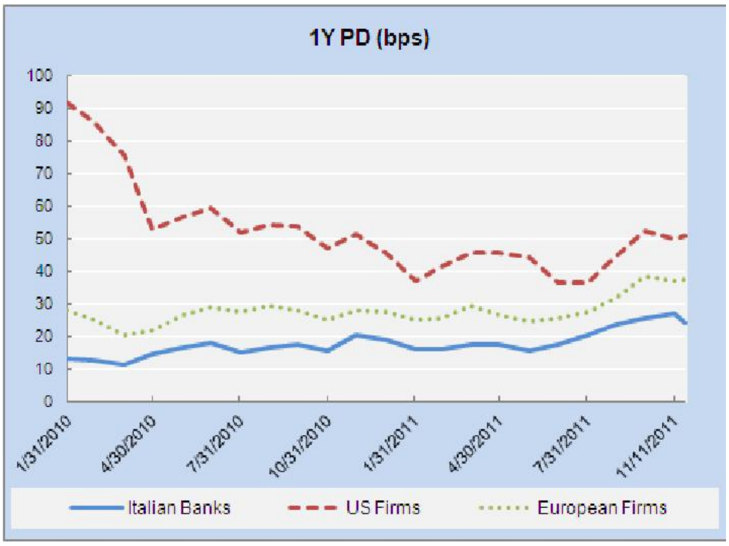
Story of the Week

Global markets look to Italy as potential liquidity crunch builds up

Italy was the focus of market anxiety the past week as investors became increasingly concerned that political turmoil would hinder efforts to stop the third biggest euro zone country from becoming engulfed by the region's debt crisis. The resignation of the Italian Prime Minster did not seem to calm the markets, as Italian 10-year yield soared to euro era highs of 7.5% after clearing house LCH.Clearnet SA increased the margin call on Italian debt. A 7% yield is seen by many in markets as economically unsustainable, given that Portugal and Ireland were forced to seek bailouts after yields on their bonds exceeded that level. Europe looked to Italy as the Senate approved a new budget law on November 13. According to RMI's default forecast model, the 1-year probability of default (PD) for Italian banks, which have large exposures to Italian government debt, increased 7.2bps to 24.0bps on November 11 from 16.8bps on June 30.



The crisis in Europe has begun to affect US bank lending as already low confidence frays further. Credit conditions have worsened, with a poll of US banks, conducted by the US Federal Reserve, showing that 15 domestic banks out of 50 have reported lower liquidity, tightened lending terms, raised interest rate spreads and decreased the amount and period for which they are willing to lend. A quarter of US banks said they had tightened conditions for lending to companies with significant exposure to Europe, and 56% said that they had tightened conditions for lending to European banks. The unwillingness of US banks to lend combined with a gloomy economic outlook underscores the financial market uncertainties which may expose US firms to a credit crunch. The 1-year PD for US firms increased 14.4bps to 50.9bps on November 11 from 36.5bps on July 31.

In Europe, banks tightened their lending conditions as they pointed to a weaker economic outlook, with a majority having a lower tolerance for risk, stating that their own liquidity position was weaker, and that it was harder to sell loans on the secondary market. The spread between three-month Euribor and the overnight index swap rate rose to 89.35bps on November 11, increasing from 86.5bps on November 7, indicating that banks were less likely to lend in prevailing market conditions. The weakened liquidity conditions are likely to reduce the availability and increase the cost of credit for European firms. The 1-year PD for European firms increased13.1bps to 37.7bps on November 11 from 24.6 bps on May 31.

Christine Lagarde, the head of the International Monetary Fund (IMF), has said that Europe's debt crisis risks plunging the global economy into a "lost decade". This gloomy global economic outlook affects firms worldwide. The 1-year PD for global firms increased 11.4bps to 52.2bps on November 11 from 40.8bps on June 30.

Read More:
Crisis in Italy spurs fears of euro zone break-up (The Economic Times)
European crisis hits bank lending (FT)
IMF chief warns world economy risks 'downward spiral' (Reuters)
Italian bond yields hit 14-year high, jitters weigh on euro (The Economic Times)
Euro government - Italian bond yields surge past 7% (Reuters)
Investors on alert for market seizure signals (FT)
Italian Senate Approves New Crisis Measures (CNBC)
Italy's bonds dragged into danger zone (FT)

Date	Country	Title	Summary
Nov 8, 2011	US	Corporate bond issuances	Demand for good quality corporate bonds remains high, as investors become increasingly concerned about sovereign debt. Issuances of corporate debt have surged in recent weeks, amidst ongoing uncertainty in the Eurozone. According to

		rebound from the lows	Dealogic, a data tracker, November 7 was the busiest day of the year with $20.3bn in new issuance in the US, including both investment grade and junk bonds. Philip Morris, Halliburton and Hershey's were among the companies that issued corporate bonds last week. Many large companies have repaired their balance sheets radically in recent years and deleveraged quickly by paying down debt, and deferring large-scale capital spending. Companies that have not experienced a significant reduction in business currently have large reserves of cash. Fund managers have found this situation beneficial, as increasing holdings of high quality corporate debt diversifies portfolios, and increases yields. Demand for corporate debt is set to increase in the near future, as more than 20 per cent of total corporate debt has matured and been repaid in 2011. **Read more:** US corporate bond issuance rebounds from lows (FT) Demand tilts from sovereign bonds to company debt (FT)
Nov 8, 2011	Spain	Spanish Banks May See $83bn Losses, BBVA Research Says	A study released last week by Banco Biliboa Vizcaya Argentaria reported that Spanish banks may face over €60bn of losses they have not provisioned for. Spanish banks hold €176bn of "troubled" real estate assets, but have only provisioned €105bn since the Spanish real estate bubble burst in 2008. The Spanish government required banks to increase their core tier one capital ratio to 9% earlier this year, and effectively nationalized three lenders on September 30 that failed to meet the new rules. The 1-year PD for the Spanish banking sector increased 40.1bps to 56.0bps on November 11, from 15.9bps on January 31. In related news, Banco de Valencia may be the next Spanish bank to be bailed out by the Spanish government, due to a recapitalization shortfall. The bank reported in a regulatory filing that it required more than €60mn in new capital, while the press reported the number could be 10 times as much. Industry analysts reported that Banco de Valencia's bad loan ratio could reach 18.5% of assets; almost the level disclosed by Banco Cam, which was previously bailed out by the Spanish government. The 1-year PD for Banco de Valencia rose 9bps to 128.7bps on November 11, from 117.7bps on October 31. **Read more:** Spanish Banks May See $83bn Losses, BBVA Research Says (Bloomberg) Banco de Valencia teeters under bad loan load (FT)
Nov 7, 2011	US	Subprime debt pain remains in the system	A study by Fitch Ratings on structured finance products has found that just a quarter of the $376bn in expected losses associated with these products has been realized. The report underscores how subprime securitizations are still affecting the financial system, with Fitch expecting that structured finance deals will eventually lose 10.6% of their original $3540bn value, from current losses of 2.7%. Fitch also expects that global financial institutions will recognize the additional losses over the next three to five years. Of the $3540bn of structured products covered by the report, Fitch believes 92% of realized and expected losses will come from residential mortgage backed securities and collateralized debt obligations. Three years after HSBC began to scale down their US consumer finance business, loan impairments on structured finance products issued before 2008 more than doubled in the third quarter to $1.8bn, from $880mn in the previous quarter. In addition to ongoing subprime securitization impairments, HSBC is facing another problem. Allegations that banks broke state laws, by allowing employees to sign off on foreclosure fillings without reviewing the underlying paperwork, resulted in a moratorium on foreclosures in most US states. HSBC reported that some of their US customers decided to take advantage of the moratorium, and skip their monthly repayments. HSBC is not alone, with Bank of America and Citigroup also reporting more borrowers falling behind on their house loans. **Read more:** Subprime debt pain remains in the system (FT) US Structured Finance losses (Fitch Ratings)

			HSBC says may leave UK, hit by US bad debts (Reuters) Subprime loans come back to haunt HSBC (FT)
Nov 10, 2011	US	Financial reform in the US	A bill introduced to the US Senate on November 10 would create a US market for covered bonds, debt securities backed by cash flows from assets on bank balance sheets. Politicians believed that covered bonds could improve the US housing market, as it could increase the ability of US banks to finance home or small business loans. However, the FDIC is concerned that such bonds may reduce the number of assets available for its deposit fund. Market participants expect the new framework to be in place by 2013, while another covered bond bill has been approved by House of Representatives, though not yet fully voted on. The SEC last week announced a proposed reform of money market funds (MMFs), with industry analysts expecting either an increase in the capital MMFs must hold against losses, or a change to a floating net asset value (NAV). MMFs aim for a stable NAV of $1 per share, which has led investors to believe that MMFs will never lose money. Fund managers are concerned that a change to a floating NAV will remove the simple accounting involved with MMF holdings, and reduce the popularity of MMFs, as they have traditionally offered better returns than bank deposits. US regulators support the reform of MMFs because banks rely on MMFs for short-term financing. Investors are more inclined to withdraw money from MMFs in times of financial turmoil; for example, investors withdrew $310bn from MMFs when Lehman Brothers failed, around 15% of the total assets of MMFs. US regulators believe the changes will decrease the risk of a similar bank run on MMFs. **Read more:** Plan for US covered bonds (FT) SEC to propose money fund reforms (FT) Money market funds resist SEC's tighter grip (FT)
Nov 7, 2011	Indonesia & Brazil	Banks in emerging markets a stark contrast to the developed world	While banks in the developed world struggle with sovereign debt problems, banks in key emerging markets are poised for huge growth. Indonesian banks are benefiting from high net interest rate margins nearing 5.5%, and rapid loan growth of over 20% per year. Rapid domestic growth is expected to insulate Indonesian banks from global financial upheaval, with fully capitalized bank balance sheets resulting from restructurings after the Asian Financial Crisis. Indonesian banks are expected to further benefit from a 50 bps interest rate cut by the Indonesian central bank this week, as loose monetary policy will further stimulate loan growth. Brazilian banks are also experiencing strong annual loan growth of almost 20%. Much of the loan growth is in secure forms of credit such as mortgages, auto loans and payroll credit. Brazilian banks remain well capitalized and profitable, as historical financial crises created a highly conservative banking culture. In addition, the controlling shareholders of Brazilian banks have unlimited personal liability. A recent review of the Brazilian banking system by Standard & Poor's rated the sector as safe as the banking systems of Taiwan and Israel. S&P noted that Brazilian banks source almost 90% of their funding from domestic deposits, insulating the sector from problems in Europe. **Read more:** Indonesia's banks build on their heady valuations (FT) Indonesia slashes interest rates by 50bp (FT) Brazil banks outshine global rivals (FT)